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Management of *Shariah* Non-Compliance Audit Risk in the Islamic Financial Institutions via the Development of *Shariah* Compliance Audit Framework and *Shariah* Audit Programme

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I. Introduction

Shariah compliance audit is conducted to enable the *Shariah* committee to express an opinion that the operations of IFIs are conducted in accordance with the fatwas, rulings and guidelines issued by the *Shariah* Supervisory Board of the Islamic financial Institutions, the accounting standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), national accounting standards and practices, and relevant legislation and regulations applied in the country in which the Islamic Financial institution operates. *Shariah* review is an examination of the extent of an IFI'S compliance in all its activities, with the *Shariah*. This examination includes contracts, agreements, policies, products, transactions, M&A, financial statements, reports and circular.

The objective of the review is to ensure that the activities carried out by an IFI do not contravene the *Shariah*. Practically in Malaysia, it is the responsibilities of *Shariah* Advisor (SA) to ensure that all products and services and related policies and agreements of Islamic Instruments are in compliance with *Shariah* rules and principles. In terms of reporting, *Shariah* Advisors shall prepare a written *Shariah* opinion report in the Bank's annual financial statement in respect of its *Shariah* compliance. Duties and responsibilities of Islamic Financial Institutions (IFI) are to refer all *Shariah* issues to the *Shariah* Advisors. The IFI also must adopt SA's advice pertaining to policies and agreements, ensure that all product documents be validated, provide access to relevant documents, provide sufficient resources to SA in terms of budget allocations, reference materials and training and remunerate the SA accordingly.

Nevertheless, there is no external *Shariah* audit being imposed in Islamic Financial Institutions in Malaysia. External *Shariah* Compliance Audit has not yet been made mandatory by the regulators in Malaysia. It is only *Imposed* internally or only a few from Islamic Financial Institutions might voluntary appoint *Shariah* Advisory firms to review on the *Shariah* matters whether it comply with the *Shariah* rules and principles or not. The reason behind this is because currently, in Malaysia there is no standard *Shariah* Compliance Audit framework that can be used as guidelines in implementing external *Shariah* compliance

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audit in Islamic Financial Institutions. A proper standard framework for *Shariah* Compliance Audit is essential to ensure the harmonization of *Shariah* practice in Islamic Financial Institutions. The development of *Shariah* audit programme is also important as to ensure the procedures (*Maqasid Shariah*) of each product in IFI are being followed. Thus, this study is aimed to develop *Shariah* Compliance Audit Framework and Audit Programme development for Islamic Financial Institutions specifically in Islamic Banking and *Takaful* institutions.

Shariah Compliance Audit Framework and Audit Programs for the products of IFIs will be able to mitigate the *Shariah* non-compliance risk as it recognises the operational issues in the IFIs that complies to the *Shariah* and other sources of attestation or otherwise. *Shariah* compliance is critical to IFIs operations and such compliance requirements must permeate throughout the *Organization* and their products and activities. As a majority of the fund providers use *Shariah*-Compliant operation as a matter of principle, their perception regarding IFIs compliance with *Shariah* rules and principles is of great importance to sustainability of IFIs. In this regard, *Shariah* compliance is considered as falling within a higher priority category in relation to other identified risks.

Shariah Compliance Audit is performed to manage the operational risk in IFIs. The principles are grouped into six categories of risks, and shall be used as the basis for Islamic Financial Institution's risk management process. A review on the principles of Islamic risk management as indicated by the Islamic Financial Services Board (IFSB) its "Guiding Principles of Risk Management for Institutions (other than Insurance institutions) offering only Islamic Financial Services"¹ document, to be discussed in Section II.

II. Risk Management in Islamic Financial Institutions

"Guiding Principles of Risk Management for Institutions (other than Insurance institutions)" published by the Islamic Financial Services Board (IFSB) categorises risks in IFIs into six categories of risks, namely; Credit risk, Investment risk, market risk, liquidity risk, rate of return risk and finally, operational risk. This paper will focus on the management of operational risk in IFIs by the way of carrying out proper *Shariah* Compliance Audit to the IFIs.

"Guiding Principles of Risk Management for Institutions (other than Insurance institutions)" presents 15 principles covering the general principles and specific risks mentioned above as follows:

2.1 General Principle

Principle 1- Islamic Financial Institution (IFI) should have a comprehensive risk management

1 Available online at: www.ifsb.org/standard/ifsb1.pdf. Retrieved on 13th July 2009.

and reporting process in place. The process should consider appropriate steps to comply with *Shariah* rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority.

2.2 Credit Risk

Principle 2- IFI should have a strategy for financing. The instruments used must be in compliance with *Shariah*, whereby it recognises the potential credit exposures that may arise at different stages of the various financing agreements.

Principle 3- IFI shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument.

Principle 4- IFI should have appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument.

Principle 5- IFI shall have in place *Shariah*-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.

2.3 Investment Risk

Principle 6- IFI should have appropriate strategies in place for risk management and reporting processes in respect of the risk characteristics of equity investments, including *Mudarabah* and *Musharakah* investments.

Principle 7- IFI must ensure their valuation methodologies are appropriate and consistent, and they should conduct the assessment on the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the IFI and the *Mudarib* and/or *Musharakah* partners.

Principle 8- IFI shall, in respect of their equity investment activities, including extension and redemption conditions for *Mudarabah* and *Musharakah* investments, exit strategies should be defined and established and must subject to the approval of the institution's *Shariah* Board.

2.4 Market Risk

Principle 9- In respect of all assets held, IFI shall have in place an appropriate framework for market risk management (including reporting) and also for those that do not have a ready market and/or are exposed to high price volatility.

2.5 Liquidity Risk

Principle 10- IFI shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their liquidity exposures in respect of each category of current accounts, unrestricted and restricted investment accounts.

Principle 11- IFI shall assume liquidity risk commensurate with their ability to have sufficient recourse to *Shariah*-compliant funds to mitigate such risk.

2.6 Rate of Return Risk

Principle 12- A comprehensive risk management and reporting process should be established by IFI in order to assess the potential impacts of market factors affecting rates of return on assets in comparison with the expected rates of return for investment account holders (IAH).

Principle 13- IFI must ensure that an appropriate framework for managing displaced commercial risk is in place, where applicable.

2.7 Operational Risk

Principle 14- IFI should have in place adequate systems and controls, including *Shariah* Board or Advisor, to ensure compliance with *Shariah* rules and principles.

Principle 15- IFI shall have in place appropriate mechanisms to safeguard the interests of all fund providers.

III. Literature Review on *Shariah* Compliance Audit

In developed economies, auditing is deemed significant because the process of wealth creation and political stability depends heavily upon confidence in processes of accountability, and how well the expected roles are being fulfilled (Sikka *et al.*, 1998). As such, the courts, regulatory agencies and various stakeholder groups have played their parts in demanding that the profession move in an expeditious fashion to meet its responsibilities as perceived by the public (see Humphrey *et al.*, 1992; Jacob, 1992; Ali *et al.*, 2006). In contrast, for countries undergoing economic transition from communism to capitalism (Sucher & Zelenka 1998; Sucher *et al.*, 1999; Hao, 1999; Sucher and Bychkova, 2001; Sucher and Kosmala-MacLulich, 2004; Lin and Chen, 2004) and in societies that have different cultural values (Hines 1992) or philosophies, the role of external auditing should be considered on its own merit since it is interwoven with historical, political, social and cultural processes.

The studies conducted on *Shariah* audit are very limited. Thus, this study attempts to venture findings related to *Shariah* audit, that later can contribute to the development of *Shariah* audit literature. To date we have writing which attempts to explore the perceptions of Accounting Academicians, Audit Practitioners and *Shariah* Scholars on the practice of *Shariah* Audit for Islamic Financial Institutions that highlights the importance of developing a proper governance of the *Shariah* compliance issues (Shahul Hameed, 2007).

In addition to that there is also study that identifies the issues and challenges of *Shariah* compliance process in the IFIs on corporate governance and *Shariah* compliance in institutions offering Islamic financial services (Grais & Pellegrini, 2006). Their study focused on the limitations in relying to the *Shariah* compliance assurance to the internal party (i.e. *Shariah* Committee). They also proposed in their study that an effective framework to monitor and assess *Shariah* compliance. This finding is similar with study conducted by Abdul Manan (2006) that finds out even though the auditors are responsible in auditing the financial statement and give reasonable assurance that the financial statement is free from material misstatement, but somehow the external auditors did not assess or audit whether the transaction made by *Shariah* listed company is free from unlawful transaction which outline by the *Qur'an* and *Sunnah*. Abdul Manan (2006) also proposed in his study that there should be a proper framework for the external auditor to audit the IFIs.

The increase in complexity of transaction and an unpredictable economy it also increases the requirement in producing *Shariah* Compliance Audit in the financial reporting. Even though there is discussion on the importance of corporate governance but the impact is still little in ensuring quality of *Shariah* auditing in financial reporting (Adawiah, 2007).

According to Engku Rabiah Adawiah (2007) there are 7 parts of *Shariah* Compliance that need to be fulfilled. The 7 parts of *Shariah* Compliance Governance can be illustrated through Figure 1 below.

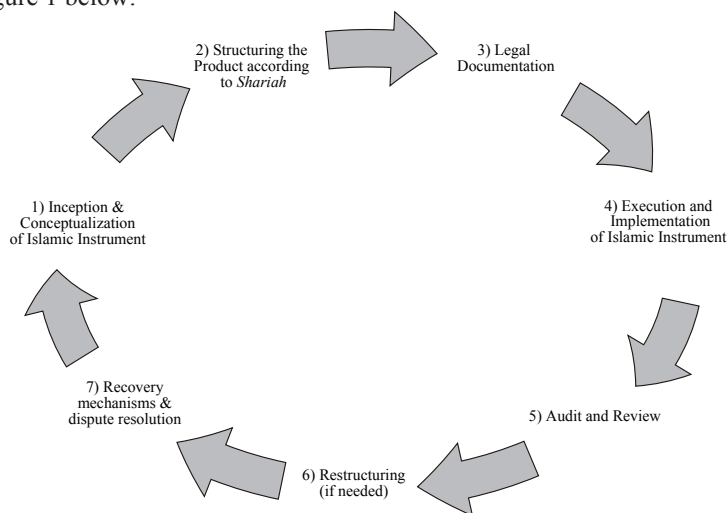


Figure 1: *Shariah* Compliance Governance

However currently the on going process of *Shariah* compliance in Malaysia are currently looking at only 3 aspects, which is inception and conceptualization of an Islamic product, structuring the rules and principles as according to *Shariah*, and legal documentation procedures. The other four parts is still an on going process in Malaysia. The audit review stage, the process is still not yet formulized at the regulatory level. Even though some banks might impose it at the internal department level such as Internal Audit department, but there is no independent party being appoint to audit the financial report of the Islamic Financial Institutions. The latest study which is more comprehensive in identifying the issues and challenges of *Shariah* audit is done by Abdul Rahim (2008). He argued that *Shariah* audit is needed to complement the current governance mechanism of Islamic financial services industry. Abdul Rahim (2008) also discussed in his paper on some challenges which considered as pre-requisites to effectively undertake *Shariah* audit.

In addition to the above, *Shariah* Advisors shall also conduct and arrange *Shariah* training programs for the Islamic Banking staff especially the internal audit department to ensure the accuracy of financial reporting for Islamic instruments. Significantly, a strong *Shariah* infrastructure is essential to ensure that Islamic financial instruments and strategies are *Shariah*-compliant. (Adawiah, 2007)

The success of any kind of audit depends on the strength of human resources. The critical success factor is having expertise to do the *Shariah* audit and having credible people setting the work plan and reviewing the results. Although *Shariah* audits have not been made mandatory, hopefully such legislation will be passed since there is a gap between issued fatwas and the respective implementations. Even though there is no legislation requiring an External *Shariah* audit, we expect the demand to grow and get more attention from the Central Bank, Securities Commissions and other Islamic Financial Institutions.

IV. Proposed *Shariah* Compliance Audit Framework and Audit Programme for Islamic Financial Institutions

Islamic financial institutions are required to operate in the *Shariah* compliant manner. This is discharged through a report signed by the *Shariah* Advisor of the financial institutions that the company is operating under the *Shariah* requirements. *Shariah* audit framework is the frame of reference to be used by the *Shariah* auditors to audit the financial statements of Islamic financial institutions before they can decide that the operation of the business is performed in the manner not contradicts the *Shariah*. At current, the practice in the banking and *takaful* industry is that the *Shariah* Advisor depends on the work of internal auditors or via the voluntary appointment of external *Shariah* auditors to audit the financial statement and determine that the financial statements reflect the compliancy of their operations with the

Shariah. This creates the need for audit framework for *Shariah* auditors, internal or external to work with. *Shariah* auditors will be better off in term of being able to conduct audit in a standardized and efficient manner with a detailed audit programme for all *Shariah* compliant products. With the help from audit programmes for every product, comparability can be enhanced.

In developing the Islamic capital market, several aspects have been laid down mainly, the prohibition of *Riba*, *Gharar*, *Maysir*, dealing in sinful activities. In addition, every contract has to be performed lawfully, following the acceptable contract objectives. These requirements can be used as the guiding principles that have to be observed by the *Shariah* Committee.

As *Shariah* audit is the process to attest that all the *Shariah* concern is being taken care of, the framework for *Shariah* audit can begin with the examination on the GPS-1 of BNM-Guidelines on the Governance of *Shariah* Committee for the Islamic Financial Institutions. The guideline states the roles of *Shariah* Committee towards the Islamic financial they are attached to. The guidelines took effect on the 1st April 2005. The guidelines has the broad objectives as to become “an effective *Shariah* framework would serve to ensure uniformity and harmonization of *Shariah* interpretations that will strengthen the regulatory framework and governance practices for the Islamic financial industry”.

Shariah compliance audit framework should enlighten the *Shariah* Committee on how they can discharge their professional duties to the board of directors, which in turn owe to the investors that the company operates under the *Shariah* guidelines.

The guidelines by the BNM aim at achieving:

- a) To set out the rules, regulations and procedures in the establishment of a *Shariah* Committee,
- b) To define the role, scope of duties and responsibilities of a *Shariah* Committee, and
- c) To define relationship and working arrangement between a *Shariah* Committee and the SAC of BNM

Part E of the Guideline states the duties and responsibilities of the *Shariah* Committee and the Islamic financial institutions. The main duties and responsibilities of the *Shariah* Committee are as follows:

- a) To advise the Board on *Shariah* matters in its business operation
- b) To endorse *Shariah* Compliance Manual. A document contains the request for advice is made to the *Shariah* Committee, the conduct of *Shariah* Committee’s meeting and the manner of compliance with any *Shariah* decision.
- c) To endorse and validate relevant documentations; including the proposal form,

contract, agreement or other legal documentation used in executing the transactions. Other documentations are product manual, marketing advertisements, sales illustrations and brochures.

- d) To assist related parties on *Shariah* matters for advice upon request
- e) To advise on matters to be referred to the SAC
- f) To provide written *Shariah* opinion
- g) To assist the SAC on reference for advice

The GPS-1 guideline can be a starting point for us to establish a *Shariah* Compliance Framework where it can enlighten the *Shariah* Committee on how to discharge their duties and responsibilities stated above. In a), the *Shariah* Committee's duties to advise the Board on *Shariah* matters in its business operation encompasses a large area of responsibilities. This proposal proposes that *Shariah* Compliance Audit to be undertaken to all the products offered by the Islamic financial institutions following the audit programs established by the IFIs and endorsed by the *Shariah* Committee. And this shall form part of the *Shariah* Committee's disposal of duties under the item a).

This guideline can act as a theoretical framework of *Shariah* Compliance Audit as the Guideline stated the scope of documentation audit falls under the responsibility of SC. *Shariah* Compliance Audit Framework may start from establishing the Audit Program to audit these documents (proposal form, contract, agreement or other legal documentation used in executing the transactions, product manual, marketing advertisements, sales illustrations and brochures) for each of the products stated as *Shariah* Compliant. The *Shariah* Compliance of the operations based on these documentations, in turn can be attested against the various sources ranging from regulations, *Shariah* guidelines, accounting and auditing standards (AAOIFI), etc.

Sources of Attestation for *Shariah* Compliance Audit for Islamic Banks consist of the following; among others:

- i. Islamic Banking Act 1983 (ACT 276)
- ii. Companies Act 1965
- iii. All guidelines and Circulars Issued by BNM regards to Islamic Banking i.e. Financial Reporting - Guidelines on Financial Reporting for Licensed Islamic Banks
- iv. Resolutions of *Shariah* Advisory Council of Bank Negara Malaysia
- v. Guidelines and Circular by the *Shariah* Advisory Council of Securities Commission
- vi. *Shariah* Standards issued by AAOIFI
- vii. Guiding principles issued by the Islamic Financial Services Board (IFSB)

- viii. Internally Developed Standards (Subject to *Shariah* Committee approval) i.e.
Company's *Shariah* Manual
- ix. Resolution and Minute meeting of Company's *Shariah* Committee
- x. Additional reference i.e.
 - The OIC *Fiqh* Academy
 - The Islamic Research Institute of the al-Azhar University
 - Practise of internal auditing standard.

4.1 Proposed *Shariah* Compliance Audit Framework

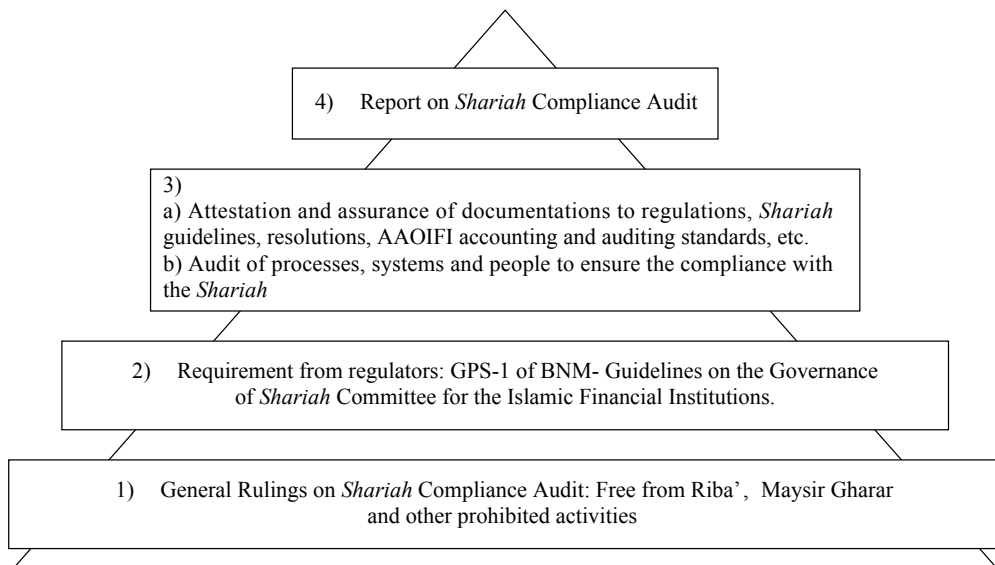


Figure 2: Proposed *Shariah* Compliance Audit Framework

Referring to Figure 2, the basic general rulings in *Muamalat* are all transactions for Islamic Financial Institutions should be free from *Riba*, *Maysir*, *Gharar* and other prohibited activities. These rules are essential and considered the most important guidelines that need to be followed and inline with *Al-Qur'an* and *As-Sunnah*.

Secondly, Figure 2 shows that the needs for *Shariah* compliance audit are because of the requirements from regulators by Bank Negara Malaysia of GPS-1 on the duties and responsibilities of *Shariah* Committee in IFIs. The first and second level of the pyramid is the preliminary stage of *Shariah* compliance audit framework.

The third level is where the auditing process of attestation and assurance on the documentations and procedures (proposal form, contract, agreement or other legal documentation used in executing the transactions, product manual, marketing advertisements, sales illustrations and brochures).

Lastly, the issuance of *Shariah* compliance audit report will take place whereby the *Shariah* auditors need to state their opinion whether the institutions comply with the *Shariah* regulations and principles or not. The issuance of *Shariah* Compliance Audit report is important to the stakeholders that require assurance on *Shariah* compliance and accountability in the Islamic Financial Institutions.

4.2 *Shariah* Audit Programme

In order to provide a guideline to the external and internal *Shariah* auditors, a comprehensive step by step audit program is vital to ensure the operation of IFIs is conducted in accordance to the *Shariah* principles. A *Shariah* Audit Program can be designed to attest the business operation of IFIs as well as the values practiced in the IFIs through observations and interviews.

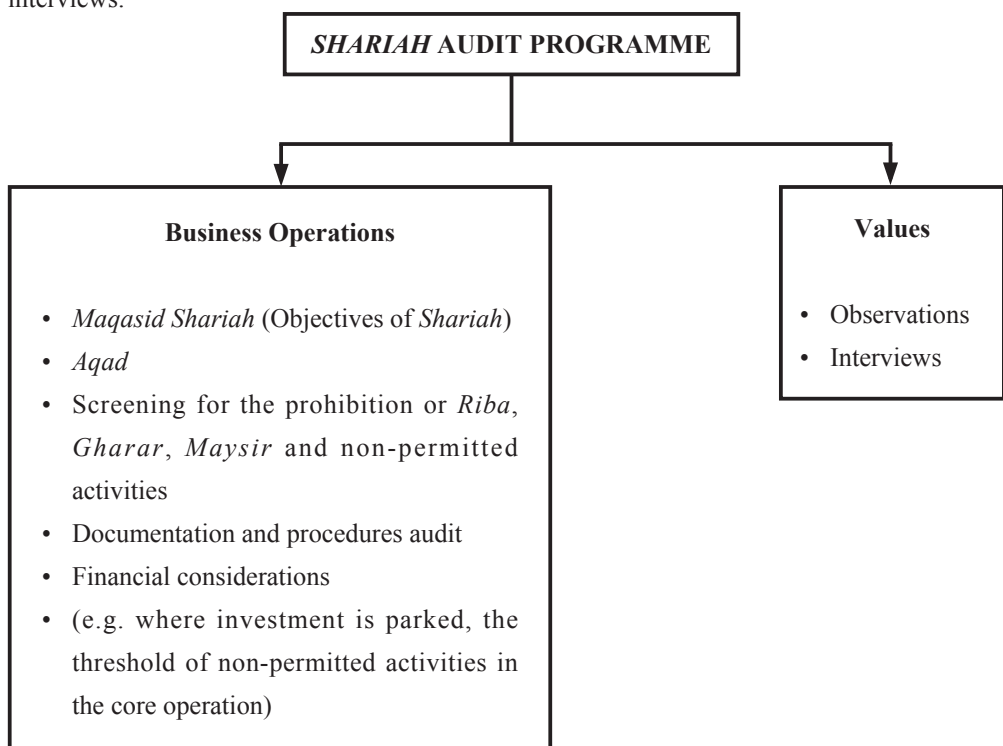


Figure 3: *Shariah* Audit Programme

V. Scope of *Shariah* Compliance Audit

The scope of work encompasses the examination of the adequacy and effectiveness of the system of *Shariah* control and the quality of performance in carrying out assigned responsibilities. *Shariah* rules and principles shall provide direction to the scope of work and activities to be reviewed.

The purpose of the examination of adequacy of the *Shariah* control system is to ascertain whether the system provides reasonable assurance whether Islamic Financial Institutions (IFI) is effective and efficient in meeting the objectives of *Shariah* compliance. The examination of the effectiveness of the system is to ensure that the system was functioning as intended. Hence effective planning, organizing and directing of the processes by the reviewers is necessary to determine whether reasonable assurance for the accomplishment of *Shariah* compliance objectives as well as other goals exist.

5.1 The Performance of the *Shariah* Compliance Audit Work

The performance of *Shariah* Compliance Audit work comprises of the following:

5.1.1 Planning and Documentation

The planning and documentation involved the following tasks:

- Establishing *Shariah* compliance audit objectives and scope of Work
- Obtaining *Shariah* Supervisory Board (SSB) fatwas, guidelines, instructions, prior year internal and external *Shariah* review results and other relevant correspondence with supervisory and regulatory agencies
- Determining the capacity as well as resources to perform the review
- Communicating with relevant parties involved with the review
- Performing feasibility survey and interview on activities, risks and controls to identify areas of emphasis
- Developing *Shariah* Audit Programs
- Determining mode and timing review results to be communicated
- Obtaining approval of the *Shariah* audit work plan from concerned authorities including SSB of IFI

*5.1.2 Examining and Evaluating Internal *Shariah* Review Information*

Shariah Auditors shall collect, analyze, interpret and document information related to *Shariah* audit objectives to support their *Shariah* audits results. Types of information are as follows:

- Examination of documents
- Observations
- Analytical reviews
- Inquiries
- Discussion with management

Quality of information should be sufficient, relevant, reliable and useful to provide sound basis for *Shariah* audit findings and recommendations.

Prepared working papers by the auditor should be complete, organized, reviewed by the head of department and retained.

5.1.3 Reporting

Quarterly reporting to the board of directors and copies to SSB and management shall be made. Prior to issuing the report the head shall discuss conclusions and recommendations with the various levels of management. Quality of report should be objective, clear, constructive and timely. The report shall include the following:

- Purpose
- Scope
- Findings
- Opinion
- Recommendations
- Corrective actions
- Feedback from those reviewed

Any dispute relating to *Shariah* interpretation to be resolved with SSB.

5.1.4 Follow Up

The internal *Shariah* auditor has a duty to follow up with corrective action and recommendations so as to ensure that the action is rectified and to prevent recurrence of non-compliance.

5.2 Management and Quality Assurance

The Head of the *Shariah* Audit is to establish plans for the review; to establish written policies and procedures to guide the *Shariah* review staff; and to establish a program to select and develop staff. It is also important to ensure that the *Shariah* review and the *Shariah* audit are properly coordinated. Furthermore there is a need to establish an effective and efficient quality assurance program to evaluate the operations of the *Shariah* audit.

5.3 Elements of *Shariah* Audit Control System

Three elements are identified by the standards as follows:

5.3.1 Employees

Only qualified, experienced and committed staff are recruited and retained as well as

continuously trained and developed. SSB involvement in the recruitment will encourage staff with the right aptitude and attitude.

5.3.2 Segregation of Duties

Non executive or operational involvement of *Shariah* auditors in the activities of IFI is observed.

5.3.3 Control Procedures

IFI management to establish controls, policies and procedures to achieve IFI objective of compliance with *Shariah* rules and principles.

VI. Conclusion

Non-Compliance risk faced by the IFIs can be mitigated through *Shariah* Compliance Audit. *Shariah* Committee who has the responsibility to express their opinion that the operation of the IFIs is fully *Shariah* compliant may rely the information from the audit work performed on various aspects of the operations including documentation, reporting and to the extend of the segregation of duties and control procures that involves documentation, system and employees involvement in the operations. *Shariah* audit will serve as a governance mechanism in Islamic finance so as it provides the verification that the IFIs operate according to the *Shariah*.

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